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BITCOINERS IN THE COURT ROOM PART II: CIVIL LITIGATION AND DEVELOPMENTS

By William B. Fleming and Joseph Evans

“[Gold 2.0](#)” is what highly visible venture capitalist Tyler Winklevoss has newly dubbed Bitcoin. While the reference doubtless is meant to analogize Bitcoin’s fixed supply to the similar characteristic of the yellow metal, Bitcoiners have perhaps also formed this generation’s gold rush. Coinciding with promises of Bitcoin profits are emerging litigation risks. In the nascent Bitcoin world some have already found themselves in courtrooms.

“Gold 2.0”

[Part I](#) of this series discussed the steps the government has taken to regulate Bitcoin, and also provided a primer explaining the basics of Bitcoin. Part II highlights private Bitcoin-related litigation and discusses alternative ways to invest in virtual currency.

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A. BITCOINICA SECURITY BREACH

A computer hacking of a Bitcoin exchange and theft of funds from its customers has led to a Bitcoin investors' suit. On August 6, 2012, a group of Bitcoin investors [sued](#) Bitcoinica LLP, a Bitcoin exchange, and its principals in California state court for breach of contract, open book account, account stated, negligence and conversion. The Complaint alleges that “[i]n 2012, Bitcoinica allegedly suffered several security breaches, in which unknown persons allegedly compromised the Bitcoinica system to steal monies held by Bitcoinica.” Bitcoinica made disbursements to investors, but the Plaintiff investors claimed they were still owed the value of lost Bitcoin that as of August 6, 2012, was the equivalent of \$460,457.70.

Of background interest to this dispute, Bitcoinica had appealed to investors because, unlike other exchanges, it allowed speculators to take short positions in Bitcoin, according to an online news [article](#). Bitcoinica also allowed Bitcoin to be exchanged for fifteen different world currencies. [Reportedly](#), under Bitcoinica's permissive trading rules, “users can leverage their bets up to a ratio of 10:1 on Bitcoinica, meaning they can lose more than their initial investment.” A further odd fact adding color to the matter is that Bitcoinica had been launched by [Zhou Tong](#), who claims to be a Singaporean teenager.

As of August 19, 2013, [Bitcoinica](#) was undergoing [liquidation proceedings](#) in New Zealand. According to the [first report](#) on February 13, 2013 by Bitcoinica's New Zealand liquidators, the company had \$500,000 worth of USD and Bitcoin on hand, and owed \$1,200,000 to customers. In

**Purportedly
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a [follow-up report](#) on August 5, 2013, the liquidators saw no end in sight and stated “litigation may be required to gain access to the funds and Bitcoins held by the trading platform.”

B. BITCOIN SERVICE PROVIDERS FIGHT OVER A LICENSING AND REVENUE SHARING AGREEMENT

Bitcoin-based companies are now involved in general business litigation with one another. On May 2, 2013, two major Bitcoin players found themselves in a [lawsuit](#) in the Western District of Washington. [CoinLab, Inc.](#), a provider of Bitcoin software and technology products, sued Japanese Bitcoin exchange giant [Mt. Gox](#) for breach of contract and breach of the implied duty of good faith and fair dealing. CoinLab also requested an accounting and actual damages of \$75,000,000. CoinLab claimed that Mt. Gox provided exchange services to North American customers in the growing Bitcoin market. In the lawsuit, CoinLab claimed that Mt. Gox breached the parties’ exclusivity agreements and revenue sharing provisions relating to those exchange services. According to the Complaint, Mt. Gox had given CoinLab an “exclusive right to certain intellectual property necessary for CoinLab to provide digital currency exchange services to North American customers” and subsequently “Mt. Gox continued to market to customers in North America and has accepted business from customers there” but “failed to provide CoinLab with account reconciliation data, server access, and other information promised in the agreement that is essential for CoinLab to market exchange services and service its customers as contemplated in the agreement.” CoinLab claimed that, despite an agreement and repeated requests, Mt. Gox failed to

Bitcoin companies are engaging in general business litigation.

deliver necessary “passwords, Yubikeys, administrative logins and [] other security information.” Also, CoinLab was denied access to Mt. Gox database records and financial data as they pertain to Bitcoin customers in the U.S. and Canada. As for the revenue sharing agreement, CoinLab claimed that Mt. Gox has not complied.¹

C. **A REGISTERED MSB SUES NON-REGISTERED BITCOIN EXCHANGES FOR ANTITRUST**

A private litigant is testing the breadth of Bitcoin-related registration requirements and the impact that a Bitcoin company’s failure to register may have in an antitrust lawsuit. In May 2013, Think Computer Corporation, a registered Money Service Business (“MSB”), [sued](#) a number of purportedly unlicensed MSBs, including Bitcoin exchanges and their investors in California under antitrust, unjust enrichment and gross negligence theories. Think reasons that unlicensed exchanges were evading rules to obtain Bitcoin customers at a rate faster than a law-abiding registered MSB ever could and Think was run out

A litigant explores the impact that Bitcoin-related Government regulations and registration requirements may have on civil litigation.

¹ This is not the first time that Mt. Gox has found itself in the court room. [Reportedly](#), in 2011, Crédit Industrial et Commercial (“CIC”) closed Mt. Gox’s subsidiary Macaraja’s bank account because “Bitcoin is an electronic money, Macaraja is not a bank, therefore it’s illegal for Macaraja to be handling this.” Mt. Gox filed suit in France claiming that its right to a bank account under French law has been violated because “Bitcoins are not an electronic currency but rather an immaterial good, like software.” The French court [found](#) (untranslated) itself incompetent to determine Bitcoin’s validity and, by default, Mt. Gox and Macaraja continued to operate. Among other things, this dispute highlights that the task of defining Bitcoin, shown in [Part I](#) of this series to be a concern to U.S. regulators, is no less perplexing to international bodies and courts, and presents issues which have quickly developed into a global concern.

of business as a result. Think named two Bitcoin exchanges as defendants.

Think specifically asserted that defendants “used massive capital infusions in unlawful enterprises as a deliberate anti-competitive tactic and ‘execution’ ‘strategy’ designed to prevent other law-abiding companies, forced to grow at a much slower or non-existent pace from being able to compete effectively in the marketplace.” Think further alleged that, as a consequence, it lost valuable business as numerous portfolio investment companies chose not to invest in Think and instead defected to the allegedly unfairly advantaged competitors.

Plaintiff cited to a [Guidance](#) issued by the U.S. Treasury’s Financial Crimes Enforcement (“FinCEN”) (discussed in [Part I](#) of this series) to establish that the Bitcoin companies are MSBs and thus subject to FinCEN and other state registration and reporting requirements because “its customers [] exchange United States Dollars for units of the digital currency known as Bitcoin” and the exchanges “hold onto clients’ funds.” Think alleged that the unlicensed entities were Plaintiff cited to a [Guidance](#) issued by the U.S. Treasury’s Financial Crimes Enforcement (“FinCEN”) (discussed in [Part I](#) of this series) to establish that the Bitcoin companies are MSBs and thus subject to FinCEN and other state registration and reporting requirements because “its customers [] exchange United States Dollars for units of the digital currency known as Bitcoin” and the exchanges “hold onto clients’ funds.” Think alleged that the unlicensed entities were not keeping up with required government regulations. According to the Complaint both exchanges had registered with FinCEN as

**A defunct MSB
sues Bitcoin
exchanges
claiming that their
failure to register
with the state gave
them an unfair
advantage.**

MSBs in April 2013 but neither, as Think claimed was required, had a money transmitter license in California or any other state. The Defendants have [moved to dismiss](#) for failure to state a claim and lack of subject matter jurisdiction.

D. BITCOIN CLASS ACTIONS

In [Part I](#) of this series, we highlighted a supposedly leaked [FBI report](#) that indicated the Government's concern about potential Bitcoin-related illegal activity, including theft and fraud. According to a putative class in California, the foreshadowed fears of subversive conduct have allegedly materialized, although perhaps in a way a bit different than expected.

On July 3, 2013 in San Francisco County, a class action was [filed](#) that claimed E-Sports Entertainment ("ESEA"), a video game company, installed malware in customers' personal computers and unbeknownst to them, the ESEA used the customers' collective computer power to mine Bitcoin. ESEA is a computer and online gaming service used by hundreds of gamers. Gamers install ESEA's software client ("Client Software") onto their computers. ESEA allegedly abused their remote software control to mine Bitcoin.

According to the Complaint, ESEA wrote a software code encrypted with malware into a Client Software update that surreptitiously hijacked the computer power of unknowing customers in order to mine Bitcoin for ESEA. This use allegedly burned out Plaintiffs' [graphics processing units](#), computer chips which perform rapid mathematical calculations most commonly used to render images.

Allegedly, a video game company installed malware onto their unknowing customers' computers in order to harness the collective power to mine Bitcoin.

Plaintiffs claim they are damaged by having to purchase new video cards and electricity used by running the malware. They also seek “any profits obtained as a result of deceptive, unlawful and misleading acts and practices,” which would likely include the purportedly ill-gotten Bitcoin.

Separately, Bitcoiners sued an exchange claiming that the Bitcoin service provider’s slow transaction speed caused them to miss out on Bitcoin profits. On July 8, 2013, a Class Action was filed against BitInstant, LLC in the Southern District of New York. BitInstant, LLC is a New York corporation that owns and operates www.BitInstant.com, a website that provides services for Bitcoiners, including account set up, maintenance, and fund transfers and they claim to be the most efficient Bitcoin processor in the business. BitInstant claims to be able to effectuate cash for Bitcoin transactions within two hours and promises customers who experience difficulty a full refund. BitInstant boasts about its speed and warns customers that if they use other slower exchanges they can lose profit because “during th[e] waiting period, exchange rates can fluctuate and you may not get the same amount you would have been able to get at the time you began your deposit.”

Plaintiffs claim that Defendant’s service claims are false and in violation of the [Electronic Funds Transfer Act](#) (“EFTA”) under sections 15 U.S.C. § 1693a(6), 15 U.S.C. § 1693a(9), 15 U.S.C. § 1693c, and 15 U.S.C. § 1693h. The Class Plaintiffs claim that pursuant to 15 U.S.C. § 1693a(6), the transactions are “electronic fund transfers” because they were initiated via electric terminal, and did not originate by check, draft, or similar paper instrument and are thereby governed by the EFTA.

Bitcoin investors sue an exchange for processing requests too slowly.

According to the Complaint, BitInstant failed to provide customers with the promised speedy service and did not refund customers for costs related to transaction delays. Due to the volatile nature of the price of Bitcoin, the Class Plaintiffs claim that the price per Bitcoin rose during the delay and they lost profit as a result. Plaintiffs seek complete reimbursement for their losses, ordering BitInstant to disgorge all profits made as a result of its deceptive practices and restitution to class members of all fees collected by BitInstant for unfulfilled services.

E. ALTERNATIVE WAYS TO INVEST IN VIRTUAL CURRENCY: A BITCOIN ETF AND BITCOIN COUNTERPARTS

Though not litigation-based, it is nevertheless of interest to Bitcoin followers that on July 1, 2013 the Facebook-shunned Winklevoss twins filed a Form S-1 registration statement for an ETF titled the Winklevoss Bitcoin Trust with the SEC. A Bitcoin ETF would provide an easier avenue for investors to speculate on Bitcoin. The [SEC filing](#) states that the “Trust holds ‘Bitcoins’” and that the “investment objective of the Trust is for the Shares to reflect the performance of a weighted average price of Bitcoins (‘Blended Bitcoin Price’), less the Trust’s expenses.” Since the conversion rate at the various Bitcoin exchanges often vary (leaving room for arbitrage as discussed in [Part I](#)), the Blended Bitcoin Price is necessary to average out the Bitcoin price. “The Blended Bitcoin Price is based on the daily average of the high and low trading prices on various Bitcoin Exchanges in the Bitcoin Exchange Market chosen by the Sponsor.” One [report](#) concludes that because of the relative size of the whole Bitcoin

An ETF may get Bitcoin to the mainstream.

market, a sizable ETF might cause prices for Bitcoin to skyrocket because of the large underlying purchases of Bitcoin the fund would necessarily have to make prior to launch. As support, the report cites a 2010 spike in the prices of underlying palladium and platinum that occurred directly after the launch of ETFs that indexed those metals. The Bitcoin ETF, if issued, is likely to make investments in Bitcoin more accessible to a larger pool of investors. If, instead of a block code and a virtual wallet, an easily tradable, relatively liquid ETF could sit next to Google and Apple in an investor's portfolio, the concerns and risks which might have prevented investors previously might largely be removed. Cameron Winklevoss [stated](#) that absent this ETF, to purchase Bitcoin “you have to be technically savvy, and there is no insurance” citing the greatest benefit of his ETF is the ease to which mainstream investors will be able to cash in on Bitcoin.

Bitcoin-knockoffs, too, provide additional investment and entrepreneurial opportunities in the virtual currency space. One ex-Google entrepreneur, Charles Lee, claims that his alternative to Bitcoin, Litecoin, fills a need. “I wanted to create something that is kind of silver to Bitcoin's gold,” says Lee. According to [Wired.com](#), virtual currency investors would have done better investing in Litecoin. “Since [January 1, 2013], Bitcoin jumped from just over \$14 to its current value of more than \$114. Back in January, Litecoin was trading in the \$0.07 range. Today, it's worth close to \$2.40. In other words, while it took 200 Litecoins to buy a Bitcoin in January, today it takes only 50.” Essentially, Litecoin

Bitcoin-knockoffs provide interesting opportunities.

allows miners to mine four times as many coins as Bitcoin does which keeps the cost per Litecoin down. This is not Charles Lee's first attempt. He previously released another virtual currency called "Fairbrix" that died because of technical problems. Litecoin is an example of the available opportunities for entrepreneurs and the virtual currency investor.

F. CONCLUSION

Bitcoin is a phenomenon. Invented at a time when angst about the reliability of fiat currencies was at its highest in recent memory, Bitcoin represents something of a throwback. The modern reality of central bankers, governmental policymakers, and other arbitrary variables being chief drivers of the value of the world's currencies can, as it has in recent years, rekindle interest in the old alternate currencies like gold and barter. Barter has been, and in many countries remains, a successful approach for determining value. Gold has for millennia retained its perception as a store of value. Like gold, the attractiveness of Bitcoin, at least in part, is predicated on its simplicity. Its worth is affected by far fewer variables, arbitrary or otherwise, than fiat currency. For one, its supply is limited and thus is, at least on its face, predicated on more basic principles for determining its true value. Only time will tell whether this fascinating experiment, already a source of much unexpected staying power, will prove, like precious metals, to be a better protector of wealth than the world's currencies.

At a minimum, Bitcoin has attracted a lot of attention. As discussed in both [Part I](#) and Part II of this series, Bitcoin-related government oversight and civil lawsuits are on the rise. Exchanges have registered with FinCEN as MSBs. The SEC has claimed that Bitcoin investments are covered by the federal securities laws and a federal judge has agreed. Alternately, private litigants present arguments that Bitcoin is not money at all. Amidst these unsettled issues, federal courts have issued seizure warrants for Bitcoin exchange related accounts. Also, the CFTC and the IRS portend to step into the fray. Lastly, other states may follow New York and California and explore the need for their own regulations where the federal government may have left a void. A well known tenet of financial regulators is that they will follow the money, the \$1 billion Bitcoin market, with roughly \$10 million changing hands daily according to one [researcher](#), is likely a magnet for further regulatory scrutiny. With the potential addition of a publicly traded [Bitcoin ETF](#) on the horizon, Bitcoin may be said to be here to stay. In stride, the Government is likely to be flexing its muscles.

To all this, it should be obvious why lawyers should care. As [stated](#) by Marco Santori, chairman of the regulatory affairs committee of the Bitcoin Foundation: “today, the best asset a Bitcoin business can have is an attorney. But few lawyers have sufficient knowledge of Bitcoin and its interaction with existing legislation, such as the Bank Secrecy Act, to advise startups.” There are Bitcoiners that may soon need representation and lawyers would be wise to keep their eye on developments. Clearly, the Government already is and private litigants are following closely behind it.

If you have any questions about this article, please contact one of the authors listed below or the GSF attorney with whom you normally consult:

William B. Fleming

(212) 768-4900

wfleming@gagespencer.com

Joseph Evans

(212) 768-4900

jevans@gagespencer.com